Office of Chief Counsel
Internal Revenue Service

memorandum

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DRMirabito

date: June 15, 2001

to: Manager, Employment Tax Specialist Group 1014
Attention: Ed Hutzmann, Employment Tax Specialist, Group 1014

from: Jody Tancer, Associate Area Counsel
(Financial Services and Health Care:Long Island)

subject: [redacted]
Employment Tax Claim

This responds to your memorandum dated April 11, 2001 requesting advice on a number of income tax and employment tax questions. Area Counsel (TE/GE), in a memorandum dated May 18, 2001 responded to your employment tax questions. Accordingly, this memorandum shall address only the related income tax issues. This memorandum should not be cited as precedent.

ISSUES

1. Are officer/shareholders entitled to a refund of income tax for the taxable year [redacted] as a result of their repayment of excess compensation in the taxable year [redacted] or must they deduct the returned compensation as an itemized deduction on Schedule A in the later year?

2. Should a deduction claimed for wages on [redacted]'s (the taxpayer or [redacted]) Form 1120 for the fiscal year ended [redacted] be reduced or should the taxpayer report additional income on its return for the fiscal year ended [redacted] when certain officer/shareholders repaid excess compensation?

CONCLUSIONS

1. The officer/shareholders may only deduct the amount of repayment on their Schedule A in the year of repayment. Since they should not reduce the amount of gross income reported in the year the excess compensation was made, they are not entitled to a refund for [redacted]. (Nor should the individuals reduce their gross income in the year of repayment.)

2. The deduction claimed by the taxpayer for wages on its Form 1120 for the fiscal year ended [redacted] should not be reduced. Rather, the taxpayer should report additional income on its return for the fiscal year ended [redacted] as a result of the repayments.

FACTS

The facts, as we understand them, are as follows:

In [redacted], the taxpayer issued stock bonuses totaling $[redacted] under the [redacted] Key Employee Stock Ownership Plan to three officer/shareholders.[1] The full amount of each person's share was reflected on their Form W-2 for the taxable year [redacted]. The stock bonuses represented [redacted] shares of [redacted] stock valued at $[redacted] per share; we understand that you do not contest the value of the shares.

After the issuance of the bonuses, civil suits were brought in the state court of Delaware and the United States District Court, Eastern District of New York, charging, among various complaints, that the taxpayer's Compensation Committee exceeded its authority by issuing the bonuses. On [redacted], the Delaware court rendered its decision and on [redacted] entered an Order providing for the cancellation of [redacted] shares of [redacted] common stock issued to the officer/shareholders. In [redacted] the defendants and plaintiffs filed appeals. Subsequently, the parties agreed to stay the appeals and allow the Delaware court to consider a proposed settlement.

On [redacted], the parties settled both suits; under the settlement, on or about [redacted], the three officer/shareholders returned [redacted] shares valued at $[redacted]. According to the copy of the settlement provided, "Although the Director Defendants [the officer/shareholders] believe that they would prevail upon appeal ..., they recognize that there is no assurance that they would, in fact, prevail upon appeal, and believe that it is in the best interests of [redacted] and its shareholders for the Director Defendants to avoid further expenditure of time, resources and the inevitable distraction that such litigation entails."

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[1] On copies of internal memoranda provided by the taxpayer and signed by each of the officer/shareholders in [redacted], these individuals are addressed as President and Chief Operating Officer, as Chairman and Chief Executive Officer, and as Vice President-Research & Development.

On [redacted], the taxpayer filed a claim for refund of employment tax (Form 843 with attached Form 941c) for the quarter ended [redacted] seeking the return of $[redacted]. Also attached to the claim were copies of Forms W-2c, Corrected Wage and Tax Statement, issued to the three officer/shareholders correcting their taxable wages for the taxable year [redacted]. Please note that for purposes of this memorandum, we assume the individual taxpayers utilize the cash basis method of accounting and a taxable year ended [redacted].

We understand that two officer/shareholders receiving the subject bonuses have not filed individual income tax returns for the taxable year ended [redacted].[2]

ANALYSIS

As noted above, Area Counsel (TE/GE) previously advised you that: (1) to the extent FICA taxes (including Social Security and Medicare taxes) were paid in [redacted] because of the erroneous issuance of stock, the return of the stock in [redacted] creates an overpayment of FICA taxes in the prior year, and credit may be claimed by the employer ([redacted]) with respect to its FICA tax liability for that prior year; (2) credit may be claimed by the employer with respect to the employee share of the FICA overpayment; and (3) the taxpayer is entitled to interest. We will not repeat the analysis of those issues here.

Issue 1.

How a taxpayer should account for a repayment of wages previously received under a claim of right depends on the year of repayment. When, as in the instant case, repayment is made in a calendar year subsequent to receipt of the amount, the amount is included in gross income in the year received under the claim of right doctrine and the taxpayer is entitled to a deduction for the amount of the repayment in the year repayment is made. Van Cleave v. United States, 718 F.2d 193 (6^{th} Cir. 1983). Further, there is no exclusion from gross income in the year of repayment for salary amounts otherwise payable used to make the repayments. See Healy v. Commissioner, 345 U.S. 278 (1953); Rev. Rul. 67-48, 1967-1 C.B. 50. Thus, generally, taxpayers who make repayments

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[2] Although a transaction code indicating the involvement of the Criminal Investigation Division appears on transcripts of account for two of the individuals, that Division advised us that as of [redacted], it is not currently investigating these failures to file income tax returns.

of reported income may only take a deduction in the year of repayment and may not reduce their gross income either in the year of receipt or in the year of repayment.

Although a cash basis taxpayer usually may take a deduction in the year in which expenses are paid under Internal Revenue Code § 461 and Treas. Reg. § 1.461-1(a)(1), Internal Revenue Code § 1341 provides for an alternative method to compute tax where, in a subsequent year, the taxpayer repays a substantial amount (exceeding $3,000) included in a previous year's income under a claim of right. See North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). This statute was enacted to alleviate some of the discrepancies between the tax benefit of the deduction in the later year of repayment versus the increase in taxes attributable to the receipt of income in the earlier year. See United States v. Skelly Oil Co., 394 U.S. 678 (1969). For a taxpayer to utilize the alternative method provided in § 1341, they must meet all of these requirements:

1. The taxpayer must have included the item in gross income in a prior tax year because it appeared at that time that the taxpayer had an unrestricted right to the item.[3]

2. The taxpayer must be entitled to a deduction for the year of repayment because it was established after the close of the prior tax year that the taxpayer did not have an unrestricted right to such item or to a portion of the item.

3. The amount of the deduction must exceed $3,000.

However, § 1341 does not allow the taxpayer to reopen the return for the year the funds were received. Shipley v. United States, 608 F.2d 770 (9th Cir. 1979). That is, this provision limits relief to an allowable deduction and does not allow the taxpayer to reduce their gross income in the year of receipt.

We again note that two of the officer/shareholders have not filed returns for [redacted]. However, the statute does not specify whether the taxpayer must include the income in question on a return or whether the statute also applies where the income is

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[3] As to the officer/shareholder who filed a return, we understand that neither party questions that the taxpayer apparently had an unrestricted right to the bonus and that he included the bonus on his Form 1040 for [redacted]. In addition, we understand that neither party questions that the subsequent civil litigation established that in [redacted] the taxpayer did not have an unrestricted right to the bonus in issue.

included in gross income by action of the Commissioner. The Court in Shipley v. United States, supra, concluded that § 1341 applied where the funds were included in gross income for the year of receipt by action of the Commissioner. The Court relied on the reason Congress enacted the statute: to permit taxpayers forced to pay taxes on income that must be repaid in a later year to recapture the full amount of the taxes paid on that income and held that this purpose applied with equal force where the taxpayer was required to pay tax pursuant to a deficiency assessed by the Commissioner. Thus, a taxpayer was entitled to a deduction under § 1341 only to the extent the funds restored were subject to taxation in the year of receipt. In the instant case, however, we understand that the individuals have not reported the subject income nor are we aware of any notice of deficiency issued to these individuals or assessments made on the Service's books and records pertaining to the stock from [redacted]. Therefore, given these facts, the nonfiling individuals are not entitled to calculate their tax liability for the year of repayment under § 1341.

Further, case law exists holding that § 1341 does not apply where a repayment is voluntary. See Pahl v. Commissioner, 67 T.C. 286 (1976)(citing Blanton v. Commissioner, 46 T.C. 527 (1966), aff'd, 379 F.2d 558 (5th Cir. 1967)). See also Rev. Rul. 62-14, 1962-1 C.B. 11. However, we do not think that any of the individuals voluntarily returned the stock despite the language in the settlement of the civil litigation. In that settlement, the individuals maintain their position that they would prevail on appeal but are settling the suits in the best interests of [redacted] and its shareholders. In addition, we do not think that these individuals, being experienced businessmen, would return the stock absent the litigation. Accordingly, we think § 1341 does apply here to the individual who filed a return as he did not voluntarily return the stock.

Generally, taxpayers may deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business under Internal Revenue Code § 162(a). Since performing services as an employee constitutes the carrying on of a trade or business, the officer/shareholders potentially could deduct the amounts of their repayments under § 162. However, since the subject repayments are due to the individual taxpayers' carrying on of a trade or business as employees, they are not entitled to deduct the amounts of their repayments "above the line". Internal Revenue Code § 62(a)(1). Internal Revenue Code § 67(b) provides that the term "miscellaneous itemized deductions" means itemized deductions other than certain listed deductions; the deduction under Internal Revenue Code § 1314 is included as a miscellaneous itemized deduction in § 67(a)(9).

Therefore, the officer/shareholders, as limited below, may only deduct their repayments on Schedule A and only if they itemize their deductions. See Rev. Rul. 79-311, 1979-2 C.B. 25.

Issue 2.

As noted above, the officer/shareholders are not entitled to reduce their gross income in the taxable year [redacted] as a result of their repayment of stock to the taxpayer pursuant to the civil litigation settlement in the taxable year [redacted]. Therefore, [redacted] is entitled to the full amount of the deduction for wages claimed on its Form 1120 for the fiscal year ended [redacted].

However, the traditional (or judicial) tax benefit rule requires taxpayers to recognize income when a deduction taken in a previous tax year is subsequently disallowed. Thus, the rule applies whenever a subsequent event that is fundamentally inconsistent with the previous deduction occurs. Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983); Kahn v. Commissioner, 108 F.2d 748 (2d Cir. 1940). See also 885 Investment Co., Enlow Ose, Tax Matters Partner v. Commissioner, 95 T.C. 156 (1990)(where a taxpayer receives a deduction for a charitable contribution in one taxable year and the donation is returned in a subsequent tax year, the fair market value of the returned property is includible in income up to the amount of the deduction).

In apparent contrast to this general tax benefit rule, Internal Revenue Code § 111 and Treas. Reg. § 1.111-1(a) provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed. (emphasis added) However, where full tax use of a deduction was made and a tax saving obtained, the recovery is viewed as income to the full extent of the deduction previously allowed. Alice Phelan Sullivan Corporation, a California Corporation v. United States, 381 F.2d 399 (Ct. Cl. 1967). However, the contrast between the statutory and judicial tax benefit rules is only apparent. Rather, the tax benefit rule is both a rule of inclusion and of exclusion: the previously deducted item must be included in income in the year of recovery while that portion of the recovery not resulting in an earlier tax benefit is excluded. Thus, the exclusionary portion of the rule merely acts to limit the inclusionary aspect. So integral are both aspects that the statutory articulation in § 111 recites only the exclusion and assumes the inclusion. Continental Illinois National Bank and Trust Company of Chicago v. Commissioner, 69 T.C. 357 (1977).

We assume for purposes of this memorandum that [redacted]'s deduction for wages taken in the fiscal year ended [redacted] did reduce its tax burden and therefore that § 111 does not apply. Should this assumption be incorrect, please contact us as our advice probably would change.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be different. If the facts change, this opinion should not be relied upon. Please note that under routing procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office, which should be in approximately 10 days. In the meantime, the conclusions reached in this memorandum should be considered to be only preliminary.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

JODY TANCER
Associate Area Counsel
(Large and Mid-Size Business)

By:____________________________
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